

**Illinois Commerce Commission
Electric Policy Meeting**

**FERC's Standard Market Design Hearing
October 15th, 2002**

**Comments of Reem Fahey on Behalf of Edison Mission Energy and
Midwest Generation**

Edison Mission Energy (EME) and its subsidiary Midwest Generation generally support and endorse FERC's Standard Market Design (SMD) initiative. The features of the proposal that relate to the structural design of competitive wholesale markets are well founded and a significant step in the right direction.

As background, Midwest Generation is a Chicago-based company which owns and operates about 9,400 MWs of fossil-fueled capacity in Illinois, which was acquired from Commonwealth Edison in December of 1999. Exelon Generation, which purchases power for ComEd, has opted to retain 4,739 MWs of this power under Power Purchase Agreements for 2003, and has released the remainder from contract.

In addition to comments addressing the specific issues requested by the ICC, EME would first like to comment on the practical implications of FERC's SMD for the State of Illinois.

Practical Implications of FERC's SMD for the State of Illinois:

Due to the state of Illinois' requirement for Illinois utilities to participate in an ISO as part of the enactment of the Illinois Restructuring Act, Illinois potentially can be well on its way to complying with FERC's SMD. This, of course, can only be achieved when the Illinois utilities fulfill their announced intentions to join either PJM or the Midwest ISO. PJM is already fundamentally compliant with the main aspects of FERC's SMD. As a matter of fact, FERC used the PJM market design as its template and blueprint in its proposed rulemaking. In addition, the Midwest ISO will also be fundamentally compliant given that its market structure is primarily a replica of PJM's successful market. However, none of the competitive benefits envisioned by both the Illinois Restructuring Act and FERC's SMD can be realized without Illinois utilities' prompt participation in PJM and the Midwest ISO. EME urges the ICC to remain focused on that specific task. Specifically, we urge the ICC to work with FERC to assure that Illinois utilities comply with FERC's July 31st Order, as follows:

- Join either the Midwest ISO or PJM by year-end.
- Be fully integrated in the energy market by year end 2003
- Eliminate rate-pancaking between MISO & PJM
- Create a single and common energy market between PJM and the Midwest ISO

If the above is accomplished, both FERC's SMD initiative and the ICC's objective of creating a successful wholesale and retail energy market as envisioned by the Illinois Restructuring Act will certainly be achieved within the state of Illinois. It is imperative that the ICC not allow the FERC SMD initiative in any way to hinder or delay the ongoing effort of both PJM and the Midwest ISO in integrating the Illinois utilities in their respective RTO choices.

The following are EME's comments in regards to the list of issues that are of particular interest to the Illinois Commerce Commission (ICC).

Independent Transmission Providers (ITP):

EME supports this element of the proposal, including the feature that combines all transmission service under one tariff for "Network Access Service." These actions will help eliminate any remaining opportunities to use native load preferences to protect utility-owned generation from competition.

EME strongly supports the transfer of functional control of transmission to an ITP (or approved Regional Transmission Organization ((RTO)) to ensure open, non-discriminatory access to the nation's transmission grid. In that connection, the transfer of the following functions to an ITP (or approved RTO) is necessary and appropriate: (a) filing and administering the tariffs for transmission and ancillary services; (b) administering day-ahead and real-time energy and ancillary services markets; (c) establishing and overseeing enforceable long-term resource adequacy requirements in coordination with state regulatory authorities; and (d) directing transmission planning and expansion on a regional basis.

EME supports FERC's SMD initiative that strives to eliminate incentives and opportunities to discriminate in the reservation, scheduling and provision of transmission service.

However, the ITP proposal appears to create an inferior surrogate for true RTOs as envisioned in Order No. 2000. This appears to disregard geographic scope considerations by accepting a company by company approach. This could potentially sustain the existing seams problems between neighboring systems.

EME urges the ICC to insist on RTO participation and not accept the inferior ITP approach. More specifically, EME has been pleased to hear the Illinois utilities publicly state their intentions to begin participating in an RTO by the end of 2002, and urges the ICC to do everything it can to ensure this, while honoring the utilities respective RTO choices.

Installed Capacity and System Reserves:

This requirement is a necessary component of Standard Market Design, and is supported strongly by EME. Particularly, given FERC's proposal to implement a bid-cap of \$1,000 MWh and potentially mitigate real-time prices during system constraints, capacity payments to generators become a critical aspect in ensuring that generation owners have the opportunity to recover their fixed costs and sustain their investments. While generally supporting FERC's resource adequacy proposal, EME believes that several specific aspects of the proposal must be changed in order for it to achieve its purposes.

First, FERC proposes that the resource adequacy requirement can be satisfied by firm bilateral contracts for power that are backed by specific generating units or a portfolio of designated generating resources. EME believes that bilateral power supply contracts need not be unit specific, but should be allowed to rely on a system portfolio of physical resources. EME also believes that in order to satisfy FERC's resource adequacy requirements, all existing and future bilateral power supply contracts that rely on system resources should be certified that such resources are physical. EME also believes that the ITP (or RTO) should run a centralized capacity auction. The auction will be used to procure capacity for deficient Load Serving Entities (LSEs) that fail to meet their resource obligation in the bilateral market. For states with retail choice (including Illinois), the capacity auction will allow retail suppliers to reconfigure offers to buy and sell into shorter term markets. A monthly auction will facilitate retail switching and resource deratings.

Second, FERC's proposed penalties for an LSE's non-compliance with the long-term resource requirement are unrealistically low and bear no relationship to the LSE's "avoided cost" of compliance. Applying penalties only if an emergency condition occurs and reliability is already compromised will encourage "free riders," rather than ensuring adequate supply. In addition, FERC's proposal to curtail (in real-time) LSEs that are short, could not be carried out in a retail choice environment, given that multiple LSEs can be on the same circuit. Inadequate penalties will not achieve the objective of inducing LSEs to make the necessary long-term supply arrangements for the simple reason that it would be cheaper to pay the penalties than to make long-term commitments for the necessary resources.

Third, in light of these considerations, EME does not believe that it is appropriate to reject Installed Capacity (ICAP) like mechanisms. ITPs should be given the opportunity to propose improvements in ICAP mechanisms that meet the Commission's resource adequacy goals.

Finally, FERC has not established how the resource adequacy requirements will be implemented in states with retail competition programs. Because load in these states can jump back and forth between utility and retail service providers, uncertainty is created with respect to the supply and cost responsibilities of load-serving entities. To ensure adequate generation supplies, EME supports FERC's proposal that resource adequacy requirements be applied to all load-serving entities.

Transmission Pricing and Congestion Management:

EME supports the aspect of the SMD proposal to eliminate rate pancaking between ITPs, which will increase the size and reach of competitive markets for generation, to the substantial benefit of both suppliers and purchasers of energy. This is especially important for the state of Illinois, which will be split between two RTOs. Elimination of rate pancaking between PJM and the Midwest ISO is critical in assuring generation located in the northern (or southern) part of the state can economically access the load in the other part of the state without being assessed multiple transmission charges. Resolution of the inter-RTO rates between PJM and the Midwest ISO is fundamental to establishing an efficient energy market within the state of Illinois. Otherwise, it would be more economical for generation in the northern part of Illinois (located within PJM) to serve loads within Ohio and Pennsylvania, than to serve load within the southern part of Illinois (located within the Midwest ISO). EME urges the ICC to fully participate in the FERC initiated investigation and settlement conference pursuant to section 206 of the Federal Power Act with regards to the rates for “Through-and-out-Service” under the Midwest ISO and PJM tariffs. This ongoing proceeding (EL02-111-000) is far more important to all electric customers within the state of Illinois than a FERC SMD NOPR, given the expedited nature of the proceeding (to be decided by February 28, 2003), as compared to FERC’s repeated postponement of the implementation deadline of the SMD.

EME supports the concept of Locational Marginal Pricing (LMP), which is a central element of eastern ISO electricity markets on which the SMD is modeled. EME has extensive experience with LMP as a participant in the PJM market through our ownership of the Homer City, Pennsylvania Generating Station. EME is very pleased that FERC is mandating the use of LMP, given that experience has demonstrated that it is the nation’s most robust and reliable congestion management system, primarily because it respects the physical limitations of both transmission and generation assets, while facilitating a successful energy market. ITPs (or RTOs) will manage congestion through the use of LMP in day-ahead and real-time markets, which will also be used to handle energy imbalances and procurement of ancillary services.

EME also supports the SMD proposal that transmission access rights be financial in nature, not physical, and that Congestion Revenue Rights (“CRRs”) be used to ensure fair and efficient use of the grid and to allow hedging of congestion cost risk.

Day-Ahead and Real-Time Markets:

EME agrees that these features of the SMD are essential, because these markets are necessary for load balancing and for managing congestion, as well as providing important market indicators of the need for investment in both transmission and generation. The day-ahead and real-time markets, however, should never be seen as anything other than for transactions “on the margin.” The bulk of supply should be contracted under the long-term resource adequacy requirement, so that excessive reliance on spot markets for energy can be avoided. If structured in that fashion, the mitigation measures for the day-ahead and real-time markets will be minimized.

Market Monitoring and Market Power:

EME supports an effective and fair market monitoring to assure the success of competitive energy markets. More specifically, EME believes that the market monitor should detect and suggest remedy to any structural market flaws to ensure that markets remain competitive. All participants in the market should be monitored including : Suppliers, LSEs, and the ITP/RTO actions.

However, EME believes that ex-post mitigation and constant price intrusion in the short-term markets by the market monitor will erode the value of generating assets, and distort necessary price signals to both buyers and sellers. Price-mitigated markets in essence will offer buyers a regulatory hedge that will have the unintended consequence of discouraging buyers from entering into long-term contracts, given that the price-mitigated short-term market will result in artificially low prices. Given that these mitigated prices will not likely reflect fixed cost, opportunity cost, emission cost and, more importantly, scarcity costs, the buyer will have a disincentive to signing long-term contracts.

It is important to acknowledge that spot electricity markets are inherently volatile due to many factors including : inelastic demand, lack of storage/inventory capability, large variance in generating unit's incremental cost, and the difficulty in forecasting load accurately due to the high correlation between weather and load demand. Given the above, high prices in real-time are not necessarily proof that market power abuse exists or there is anti-competitive behavior. EME believes that if the resource adequacy requirement and regional transmission planning are structured properly, infrastructure in both generation and transmission will be adequately developed. This should result in competitive markets, minimizing the need for the market monitor to mitigate short-term markets.

A Cost-Benefit Analysis with a Focus on Illinois and the Midwest Region.

EME believes that the ICC should rely on the joint Cost-Benefit Analysis co-sponsored by both PJM and the Midwest ISO. Energy Security Analysis Inc. (ESAI) conducted an independent and thorough analysis that enumerated the benefits that would be captured in a joint energy market between PJM and the Midwest ISO. The results of the study show significant consumers benefits in savings of \$7 billion over ten years.